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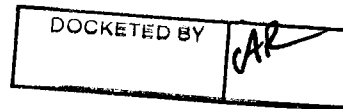
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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

DOCKETED

JUL 10 2002



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COMMISSIONER

IN THE MATTER OF THE GENERIC) DOCKET NO. E-00000A-02-0051
PROCEEDINGS CONCERNING ELECTRIC)
RESTRUCTURING ISSUES)

IN THE MATTER OF ARIZONA PUBLIC) DOCKET NO. E-01345A-01-0822
SERVICE COMPANY'S REQUEST FOR)
VARIANCE OF CERTAIN REQUIREMENTS)
OF A.A.C. R14-2-1606)

IN THE MATTER OF THE GENERIC) DOCKET NO. E-00000A-01-0630
PROCEEDING CONCERNING THE)
ARIZONA INDEPENDENT SCHEDULING)
ADMINISTRATOR)

IN THE MATTER OF TUCSON ELECTRIC) DOCKET NO. E-01933A-02-0069
POWER COMPANY'S APPLICATION FOR)
A VARIANCE OF CERTAIN ELECTRIC)
COMPETITION RULES COMPLIANCE)
DATES)

IN THE MATTER OF THE APPLICATION) DOCKET NO. E-01933A-98-0471
OF TUCSON ELECTRIC POWER COMPANY)
FOR APPROVAL OF ITS STRANDED COST)
RECOVERY)

**POST-HEARING
BRIEF OF ARIZONANS FOR
ELECTRIC CHOICE AND
COMPETITION**

1 On June 28, 2002 the Chief Administrative Law Judge directed the parties in the above-
2 captioned proceedings to file briefs addressing the Track A issues identified in the Procedural
3 Order dated May 2, 2002. Arizonans for Electric Choice and Competition ("AECC") hereby
4 submits this post-hearing brief on the issues identified in the Procedural Order.

5 **I. TRACK A ISSUES ARE THE ONLY ISSUES PROPERLY BEFORE THE**
6 **COMMISSION AT THIS TIME**
7

8 The Commission's Procedural Order identifies the following Track A issues to be
9 addressed in the recently completed hearings: transfer of assets; market power; code of
10 conduct/affiliate rules; and jurisdictional issues. In responding to the Procedural Order, AECC
11 did not extend its direct testimony to other issues, and with the exception of the brief notation to
12 follow, will limit its brief to the Track A issues. Two other parties to this proceeding, namely
13 RUCO and Tucson Electric Power ("TEP"), have introduced into the record proposed changes to
14 Arizona's retail direct access program, a subject matter that is clearly outside the scope of the
15 Track A issues list, and also outside the scope of the issues heretofore considered in other phases
16 of this docket (i.e., Track B and the APS Variance Request). AECC strongly objects to the
17 changes proposed by these parties, as explained in the Rebuttal Testimony of Kevin C. Higgins.¹
18 Moreover, AECC views the proposal interjected by TEP into this proceeding to be a bad faith
19 attempt to advance its pre-settlement agreement objectives. AECC notes that in setting the topics
20 for this briefing, the Chief Administrative Law Judge has appropriately excluded the issue of any
21 re-design of Arizona's direct access program. Accordingly, AECC will not burden this record
22 further with any additional discussion of this topic, except to reserve its right to argue against the

¹ Higgins, rebuttal testimony at 1-4.

positions advanced by RUCO and TEP on this topic in an appropriate forum, should it ever be considered.

II. SOLUTIONS TO THE TRACK A ISSUES CAN, AND TO THE GREATEST EXTENT PRACTICABLE SHOULD, BE PURSUED WITHIN THE CONTEXT OF THE APS AND TEP SETTLEMENT AGREEMENTS.

AECC signed and supports the APS and TEP Settlement Agreements, continues to believe that they are in the public interest, and urges the Commission to continue to adhere to and enforce them to the greatest extent possible. In adhering to, and advocating for, those agreements, however, AECC is not suggesting that the Commission ignore critical policy issues. As discussed in more detail in Section IV of this brief, and as recognized by almost all of the parties to this proceeding, the potential that market power could unfairly impact retail prices after divestiture and after the termination of existing price caps is a critical public policy issue that still must be resolved. AECC submits that this critical public policy issue can properly be resolved within the context of existing rules, orders and agreements. Specifically, AECC recommends that the Commission take the following actions:

1. In Track B, the Commission should determine the proper timing and amount of the generation resources needed to meet standard offer load that can and should be procured through competitive bids pursuant to 1606(B), and should require full compliance with that determination. The Electric Competition Rules ("Rules") may need to be amended to the limited extent necessary to accommodate these Track B decisions.

2. The Commission should direct the parties to the APS and TEP settlement agreements (and other parties of interest) to make a prompt, good faith effort to address the following issues within the framework of the settlement agreements:

1 (a) timing of divestiture – the parties should consider the need to modify the
2 timing of divestiture, as necessary, to comport with the Track B findings, (e.g., in the
3 event that competitive bidding is delayed, then divestiture may be delayed); alternatively,
4 APS can bring forward, for the consideration of the other parties and the Commission, a
5 power purchase agreement that provides a short-term “bridge” through 2003, to the
6 extent such a product is needed to supplement APS’ standard offer requirements in light
7 of Track B findings;

8 (b) longer-term power purchase agreement -- APS can bring forward, for the
9 consideration of the other parties and the Commission, a power purchase agreement that
10 provides long-term resources using today’s rate-based generation as part of a portfolio
11 that is limited to meeting demand *beyond* the standard offer requirements that are
12 competitively bid (as determined in Track B).

13 (c) market power – the parties, including the Commission, should seek a
14 consensus approach to market power testing, monitoring, and mitigation, and should pro-
15 actively seek adoption of that approach by FERC.

16 Consensual resolutions to these issues will be presented to the Commission for approval, and
17 may require conforming amendments to the Rules.

18 3. To the extent the parties are unable to reach consensual resolutions of the identified
19 public interest issues within a specified timeframe, the Commission should exercise its authority
20 as necessary to protect the public interest, using every reasonable effort to allow impacted parties
21 to the affected settlement agreements to retain the benefit of their bargain.

1 **III. THE TRANSFER OF ASSETS CONTEMPLATED BY THE SETTLEMENT**
2 **AGREEMENTS AND THE RULES SHOULD PROCEED, EXCEPT TO THE**
3 **EXTENT THE PARTIES AGREE TO MODIFICATIONS OR THE PUBLIC**
4 **INTEREST CANNOT ADEQUATELY BE PROTECTED.**

5
6 The Electric Competition Rules require that affected utilities separate their competitive
7 generation assets either to an unaffiliated party or to a separate corporate affiliate by January 1,
8 2001.² Both the APS and TEP Settlement Agreements provide two-year extensions to this
9 deadline.³ The APS Settlement Agreement builds upon the general divestiture requirements in
10 the Rules, and specifies particular terms that are integral features of the settlement package.⁴

11 Issues relative to market power and the wholesale market were addressed by numerous
12 parties in this docket, including APS. The concerns expressed by APS and others about the near-
13 term viability of the wholesale market make it difficult for divestiture to proceed within the time
14 frame contemplated by the APS Settlement Agreement.⁵ APS, for example, has characterized
15 the western wholesale market as “not functioning properly” because liquidity has “gone in the
16 tank.”⁶ APS’s proposed remedy to this problem is a long-term Power Purchase Agreement (PPA)
17 with its affiliate, Pinnacle West Energy Corporation (PWEC). However, the specific PPA
18 proposed by APS is opposed by many parties, including AECC, in part because it would crowd
19 out the ability of new suppliers to compete for APS’s standard offer business. To the extent that
20 the Commission is not enamored with the proposed PPA, but otherwise shares APS’s concerns
21 about the wholesale market, the Commission will naturally be hesitant to allow divestiture to

² R14-2-1615(A).

³ APS Settlement Agreement, Section 4.1(1) [per Addendum]; TEP Settlement Agreement, Section 3.1.

⁴ See, for example, APS Settlement Agreement, Sections 4.2 and 4.4.

⁵ Higgins, transcript at 1176, lines 10-24.

⁶ Davis, transcript at 90, lines 6-7.

1 move forward on the current schedule without sufficient protections in place to protect the public
2 interest.

3 The primary public interest concern of divestiture is the potential market power in the
4 APS territory that could be conveyed to PWEC upon the asset transfer.⁷ Although Dr.
5 Hieronymous' market power analysis indicates that PWEC would easily pass FERC's new
6 "supply margin assessment" market power test,⁸ his analysis looks at *next year's peak demand*
7 *period* – midway through 2003 – *after* significant merchant generation is scheduled to be on line.
8 In contrast, Mr. Davis' largely bleak observations about the *current* wholesale market essentially
9 describe a *pre-Arizona-merchant* generation marketplace. The difference between these two
10 portrayals is essentially one of timing. As Mr. Higgins concluded, on January 1, 2003, significant
11 PWEC market power may indeed exist, assuming divestiture goes forward on schedule.⁹

12 AECC recommends that the Commission address this market power timing problem
13 both by directing the parties to the Settlement Agreement to convene prompt settlement
14 discussions as suggested above, and also by utilizing the Track B process in this docket to
15 determine the proper timing and amount of the standard offer load that can and should be
16 competitively procured pursuant to Rule 1606(B), and then requiring full compliance by APS
17 and TEP with that determination. In conjunction with this step, the Commission should consider
18 using a short-term power purchase agreement between APS and PWEC as a means of mitigating
19 market power concerns. A short-term agreement could serve as a bridge to the extent that the
20 Track B evaluation determines that APS will need to supplement competitive bidding for a

⁷ Higgins, transcript at 1177, lines 13-23.

⁸ Hieronymous, direct testimony at 32, lines 6-10.

1 period of time in order to procure sufficient resources to provide standard offer service. This
2 short-term agreement can fill the need for system resources for standard offer service while new
3 generation is completed. Also, any market power that PWEC may attempt to exercise vis-à-vis
4 its affiliate APS in 2003 cannot be passed through to standard offer customers, as the Settlement
5 Agreement retail rate cap provisions will still be in effect.

6 In addition, after the Track B parameters have been established, the Commission may
7 also wish to consider some kind of longer-term power purchase agreement between APS and
8 PWEC to provide longer-term resources using rate-based generation as part of a portfolio to meet
9 demand *beyond* the standard offer requirements that are competitively bid.

10 AECC believes that by addressing timing, Track B, and power purchase agreement
11 issues as suggested above, divestiture by APS may proceed as scheduled. Alternatively, this
12 approach would also accommodate a delay in divestiture to address concerns raised by the
13 Commission, to the extent that such a provision could be negotiated among the parties.

14 **IV. MARKET POWER ISSUES CAN BE ADDRESSED BY EXISTING PROTOCOLS**
15 **AND BY NEGOTIATING A PROACTIVE ARIZONA MARKET POWER**
16 **MITIGATION PLAN**
17

18 One of the chief concerns in this proceeding is ensuring that retail customers will not be
19 victims of market power abuse after the expiration of standard offer price caps. AECC believes
20 that if the right steps are taken, as discussed in this brief, the public can be protected against
21 market power abuse in the context of restructuring.

⁹ Higgins, transcript at 1177, lines 21-23

1 Prevention of vertical market power abuse is currently being vetted through FERC's RTO
2 development process.¹⁰ Horizontal market power can be manifested in two basic forms: load
3 pocket market power and a more "generalized" market power. Load pocket market power can
4 adequately be mitigated in the near-term by the FERC-approved must-run generation protocol
5 incorporated into the Arizona ISA tariff, which provides wholesale price caps and operating
6 procedures for load pocket conditions. Load pocket market power concerns thus need not be an
7 impediment to divestiture, so long as the Arizona ISA protocols are enforced. In the longer term,
8 mitigation of load pocket market power will be under the purview of an RTO. The WestConnect
9 RTO filing currently before FERC contains provisions for mitigating market power in load
10 pockets that are similar to those of the Arizona ISA, but which allows generation owners to sell
11 at market prices (established outside the load pocket) and establishes a framework for creating
12 proper incentives for generation to be constructed inside the load pocket.¹¹

13 One of the best preventative measures against horizontal market power is the
14 development of new competitive generation resources provided by a diversity of suppliers. This
15 is exactly the course that Arizona embarked upon with the passage of the Rules and the
16 development response has been impressive. As discussed in Section III above, one of the main
17 challenges in taking advantage of the new generation will be in the timing: how to structure the
18 competitive bidding program to take maximum advantage of the new supplies coming on line,
19 while also providing for the continued use of existing rate-based resources in a manner that is
20 fair and reasonable to customers and owners. The course of action described in Section III will

¹⁰ Higgins direct testimony, p. 10, lines 4-14.

¹¹ Higgins direct testimony, p. 6, line 1 – p. 9, line 17.

1 allow Arizona to meet this objective, yet it will still be necessary to put in place a market power
2 testing, monitoring, and mitigation plan to serve as a backstop in the event that a horizontal
3 market power situation develops. Ultimately this plan will need to be incorporated into the
4 market monitoring function of whatever RTO is put in place in Arizona. Such a plan will be most
5 effective if it can be developed by consensus among the stakeholders – including the
6 Commission – and proactively pursued as an “Arizona market power mitigation plan” filed at
7 FERC.¹² This mitigation plan should provide for capped pricing – either tied to cost-of-service or
8 an external market index – combined with a “must-offer” obligation during periods when market
9 power is projected to be present.¹³ AECC also recommends that the Residual Supply Index (RSI)
10 screen, developed by the California ISO Department of Market Analysis, be used for market
11 power testing purposes.¹⁴

12 **V. THE COMMISSION WILL RETAIN JURISDICTION SUFFICIENT TO**
13 **PROTECT THE PUBLIC INTEREST**
14

15 Assuming the steps identified in this brief are followed, the Commission will retain the
16 power and jurisdiction to protect the public interest. Since the adoption of the Rules, it has been
17 the policy of the state of Arizona that the acquisition of resources to provide standard offer
18 service would be acquired in the wholesale market upon divestiture of utility generation assets,
19 which would mean a larger role for FERC jurisdiction. Through the use of proper steps to
20 protect the public interest, as discussed above, and through the Commission’s oversight over the

¹² Higgins, direct testimony at 15, line 9 – 16, line 2.

¹³ Higgins, direct testimony at 14, lines 19-22.

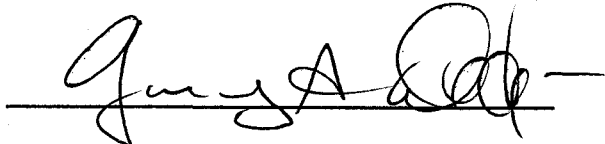
¹⁴ Higgins, direct testimony at 12, line 3 – 13, line 2. Also discussed in Hieronymous, rebuttal testimony at 34, line 16 – 36, line 10.

1 prudence of wholesale purchases, the Commission will have adequate power to protect the public
2 interest of power users in the State of Arizona.

3 **VI. CONCLUSION**

4 AECC respectfully submits that the Commission and the other parties to the APS and
5 TEP Settlement Agreements (and potentially other parties of interest) should make prompt, good
6 faith efforts to address the key Track A public policy issues of divestiture timing and market
7 power within the respective frameworks of those agreements. AECC believes that the best
8 solution to these issues will include competitive bidding to the extent determined available and
9 appropriate in Track B, a short-term "bridge" power purchase agreement, a longer-term power
10 purchase agreement, and a proactive approach to market power testing, monitoring, and
11 mitigation. Finally, all retail customers should retain their hard-won right to shop, which will be
12 an important source of customer leverage going forward, particularly as merchant generation
13 comes on line and stranded costs are paid off.

1 RESPECTFULLY SUBMITTED this 10th day of JULY, 2002.

2
3 

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